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No. 677

In the Supreme Court of the United States

OCTOBER TERM, 1966

THE A. P. SMITH MANUFACTURING COMPANY,
PETITIONER

v.

THE UNITED STATES

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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v.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

This is a petition for a writ of certiorari to the United States Court of Claims to review the judgment in a suit for refund of federal income taxes. The jurisdiction of the Court of Claims was based on § 7422, I. R. C., and 28 U. S. C. § 1491.

The suit was based on claims for refund of taxes paid on additional assessments for 1954 and 1955 (R. 333, 346-7). The 1954 assessment (R. 54-6) ruled that when petitioner contributed to its pension plan securities which on the date of contribution had a quoted market value $53,834.07 higher than petitioner's cost, petitioner realized that amount as ordinary income although at the close of the taxable year the securities remained partly unsold (R. 141-2, 250).[1] The 1955 as-

[1] The trustee was subject to investment direction only with respect to annuity and insurance contracts, not securities (R. 34, 41-5).

sessment (R. 56-8) made a similar ruling with respect to securities wholly unsold (R. 142-3) at the close of the taxable year, the excess of market value over cost being $34,866.67. As a first alternative the assessments reduced by the equivalent amount petitioner's deduction for each contribution and as a second alternative they taxed the amounts as capital gains. Petitioner paid the taxes at ordinary income rates, as it was obliged to do (R. 346), and filed its claims for refund. Petitioner then brought this suit, alleging in its complaint (R. 10, 14) that in assessing the deficiencies the Internal Revenue Service had construed the statute erroneously or that, if correctly construed, the statute was unconstitutional. On the Government's concession (R. 333) the court below adopted the second alternative and gave judgment for petitioner for the excess of the taxes at ordinary income rates over those computed at capital gains rates (R. 329-330). Petitioner seeks review by this Court on the sole issue decided, namely, whether petitioner realized capital gains.

OPINION BELOW

The opinion below is reported at — Ct. of Cl. —, — F. 2d —, 18 A. F. T. R. 2d 5130.

JURISDICTION OF THIS COURT

The judgment below was entered July 15, 1966. The jurisdiction of this Court to review the judgment by writ of certiorari is based on 28 U. S. C. § 1255. The Chief Justice, on October 13, 1966, extended the time for filing this petition to October 14, 1966.

QUESTION PRESENTED

Whether the contribution of securities by an employer to its pension plan realizes as taxable capital gain the difference between the employer's cost in the

securities and their quoted market value on the date of contribution, where the plan was a self-administered fixed benefit plan for granting to retired employees pensions in the form of life annuities, where the contributions were made in accordance with the level premium method of accumulation, and where in the case of one year's contribution the securities remained wholly unsold at the end of the year of contribution and in the case of the other year's contribution the securities remained partly unsold.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The constitutional and statutory provisions involved are Article I, § 2, cl. 3, and Article I, § 9, cl. 4 of the Constitution, the Sixteenth Amendment, and §§ 61, 162(a), 404(a) and 1001, I. R. C., the pertinent provisions of which are set forth in the appendix to this petition.

STATEMENT OF THE CASE

The court below chose a broad base for its decision. The court found that petitioner's plan "is fairly standard and so can be considered not only in terms of its particular provisions and statistics, but in terms of principles applicable to pension plans generally" (R. 342-3). This was in accordance with the manner in which it was sought to present petitioner's case. According to Mr. Murray Webb Latimer, perhaps the country's leading pension expert (R. 203-4), petitioner's plan is basically similar to "many thousands of plans of other employers" (R. 264).

Petitioner's plan (R. 17-53) is a fixed benefit plan for granting retirement pensions in the form of life annuities, the amounts of the pensions being deter-

mined in accordance with an announced formula based on salary and length of service (R. 25-8, 50-1).[2] By making an assumption as to future salary each employee can estimate his pension. The plan is self-administered in that pensions are paid by the trustee out of a pension trust (R. 41-9) "forming part"[3] of the plan, i.e., an instrumentality for segregating, accumulating and investing contributions and disbursing pensions. There is no contract with an insurance company or other outside agency for the payment of pensions. Bankers Trust Company, the trustee of the pension fund, is obliged only to use its best efforts in investing the contributions which it receives, and to pay pensions therefrom as directed, to the extent of the property from time to time in its hands (R. 341, 140, 41-9).

The plan is "qualified" within the meaning of § 401(a), I. R. C. (R. 332, 341-2).

In 1954 and 1955, petitioner, having undertaken a costly foundry modernization program (R. 156), made its contributions to the plan largely through transferring from its treasury to the pension fund securities of other corporations (R. 332-3, 343-4) which it had been holding for a rainy day (R. 160-1). In respect of those contributions petitioner deducted the quoted market value of the securities on the dates of transfer (R. 344-6).

In the court below petitioner pointed out that it could have realized gain by the contribution only if it

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[2] The plan gives employees the option of contributing and thereby receiving a larger pension and certain death benefits; but those features are in no way involved in this case.

[3] § 401(a), I.R.C.

had received in exchange something having a value greater than petitioner's cost in the transferred property. Petitioner offered evidence which showed that it received nothing in exchange for the contributions; that it received the employer advantages of the plan in exchange for something else, namely the employee expectation of pensions; and that the contributions were mere deposits of unliquidated property on account of the aggregate present and future indeterminate costs of the plan. In a little more detail, petitioner's proof on this point was as follows.

In the case of a plan like petitioner's, the cost of pension benefits accrued to a given point in time cannot be known until about sixty years thereafter when all employees either have lost their pension rights through severance or pre-retirement mortality, or have retired and lived out their post-retirement lives (R. 306). Meantime actuarial costs can only be estimated. These estimates are always wrong "except by pure chance" (R. 267); and typically the error is of significant magnitude (R. 268-74). For example, petitioner's conservative actuarial assumptions, reported to and accepted by the Commissioner of Internal Revenue, produced an error of 16.9% or $124,794 in the estimated cost of benefits in force as of the effective date of the plan, December 1, 1944, as determined by petitioner's experience up to October 1, 1962; and even that, of course, was not the final figure (R. 297-300).[4] In

[4] Shortly after December 1, 1944, the cost of pensions in effect under the plan at that date was estimated at $737,014. Up to October 1, 1962, the actual facts showed that cost would be at least $861,808. In Mr. Latimer's opinion, petitioner cannot expect to know the actual cost of the pensions in force in 1948 until about the year 2000 (R. 303).

plans of this kind the process of correcting for error in estimating cost goes on as long as the plan is in existence (R. 267).

In the case of a plan funded by the level premium method, like petitioner's, the estimated cost of each employee's aggregate pension by reason of service from entry into the plan to retirement is divided into equal segments, in rough analogy with the premiums on a policy of whole life insurance (R. 281-91). In view of the declining force of interest, these segments are never equal to the estimated cost of the increment of pension which accrues by reason of the service of the employee during the year of contribution (R. 285). There are other recognized methods of accumulation, each of which, for a given sum and a given period of time, would produce a different series of periodic contributions.[5] To be tax deductible, an employer's contributions to a qualified plan need only be based on costs estimated and accumulated by any accepted actuarial method and on reasonable assumptions.[6]

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[5] Four such methods are compared at R. 109. The single premium method is described at R. 276-81. The level premium method without discount for withdrawals is discussed at R. 281-5; with discount for withdrawals at R. 285-9. The level percentage of pay roll method, which assumes salary increases, is discussed at R. 281-5.

[6] The statute provides that the maximum deductible amount may be determined under "A," "B" or "C" of § 404(a)(1). Petitioner, like most employers, computes its deductions under "C." (R. 230). The regulation under § 404(a)(1)(C) is § 1.404(a)-6, of which the applicable portion is as follows:

> "(2) Subject to the applicable general conditions and limitation . . . deductions may be allowed under section 404(a)(1)(C) to the extent of limitations based on normal and past service or supplementary costs of providing benefits under the plan. 'Normal cost' for any year is the amount actuarially determined which would be required as a con-

In view of the highly conceptional nature of the process by which the amount of year by year pension funding is determined and the imprecise nature of the results, it is not surprising that petitioner's employees pay no attention to such funding and that the consideration for petitioner's receipt of the employer advantages of the plan—increased personnel efficiency and ability to recruit and hold desirable employees, and to effect timely retirements (R. 260, 149, 341)—is the expectation of the employees that pensions in accordance with the formula will be paid punctually, whatever may be the cost, however and whenever petitioner may fund that cost, and whatever may be the value of the pension trust on a given date (R. 262-4, 307-8).

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tribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. Past service or supplementary cost at any time is the amount actuarially determined which would be required at such time to meet all the future benefits provided under the plan which would not be met by future normal costs. . . .

"(3) The limitation under section 404(a)(1)(C) for any taxable year to which this paragraph applies is the sum of normal cost for the year plus an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan. For this purpose the normal costs may be determined by any generally accepted actuarial method and may be expressed either as (i) the aggregate of level amounts with respect to each employee covered under the plan, (ii) a level percentage of payroll with respect to each employee covered under the plan, or (iii) the aggregate of the single premium or unit costs for the unit credits accruing during the year with respect to each employee covered under the plan, provided, in any case, that the method is reasonable in view of the provisions and coverage of the plan, the funding medium, and other applicable considerations."

Thus the employee advantages of the plan flowed toward petitioner equally in years when it made no contribution as in years when it contributed the full amount called for by its method of accumulation; and no employee or employee representative, in or out of collective bargaining sessions, has inquired about or discussed the funding of the plan (R. 152-5, 178, 259, 263). This parallels the experience of United States Steel Corporation with a similar plan (R. 304-5, 212-13). Likewise petitioner received the employer advantages of the plan equally when the liability for past service benefits, estimated at $266,610, was wholly unfunded as thereafter when the estimated cost of those benefits had been fully funded (R. 153, 178-9, 244).

Despite the impossibility of any reasonably current cost determination, petitioner must, like other employers, keep its pension plan in full force in order to remain competitive in today's labor market (R. 206-7, 209-11, 216-17). In the case of a self-administered fixed benefit plan like petitioner's, this means paying out all pension installments punctually, whether or not actuarial costs and costs of administration have been underestimated and whether or not the pension fund has been depleted by investment losses or through failure to earn the rate of return assumed in predicting costs (R. 166-8, 174, 343).

Finally, in each of the taxable years 1954 and 1955, it was unknown how far petitioner's contributions would go even as a deposit on account, since, as aforesaid, the securities contributed in 1954 remained partly unsold at the end of that year; and those contributed in 1955 remained wholly unsold at the close of the latter year.

On this uncontested evidence, showing that in each taxable year there was no completed and closed trans-

action on which gain or loss was realized by petitioner in respect of the pension plan, petitioner asked the Trial Commissioner to make findings and to conclude therefrom that petitioner was entitled to recover the full amount of the taxes paid (R. 73-127, cf. R. 340-7). Accepting the Government's view of the case, the Trial Commissioner refused to make findings on these facts as not "germane to the issue" (R. 338). Instead, he decided the case on the following three propositions of law:

> (1) " 'When the taxpayer evaluated the contributions on the basis of the then current market value and used those figures for its deductions, it then realized capital gain to the extent that such values exceeded its basis. *There is no gainsaying this logic*' " (R. 339. Emphasis by the Commissioner).
>
> (2) "... the completion and closing of the transaction within the taxable year is inherent in the allowance of the deductions as 'ordinary and necessary' expenses" (R. 339).
>
> (3) Petitioner "cannot have it both ways. ..." It cannot validly, on one tax return, deduct its contribution as ordinary and necessary expense and then contend that it did not realize gain by the contribution on the ground that the cost which it incurred for the employer advantages of the plan in the year of contribution "cannot be determined until after the lapse of some 40 to 70 years. * * * ... a taxpayer cannot circumvent the capital gains tax by a device, simple or complex." In dealing with petitioner's claim for a deduction for its pension plan contribution for each of the years in question, the court will not go beyond recognizing such contributions "as compensation for services actually rendered, within the meaning of the statute. ..." And the

transfer of appreciated property in payment of compensation realizes the appreciation (R. 339-40).

The court confirmed the Trial Commissioner's report and adopted his opinion (R. 329).

REASONS RELIED ON FOR GRANTING THE WRIT AND ARGUMENT IN SUPPORT THEREOF

I

IN THE CASE AT BAR THE COURT OF CLAIMS HAS DECIDED IMPORTANT QUESTIONS OF FEDERAL LAW WHICH HAVE NOT BEEN BUT SHOULD BE SETTLED BY THIS COURT.

Whether under the state of facts here obtaining the contribution of appreciated securities to petitioner's pension plan realized the appreciation raises a question as to what constitutes income in the form of capital gain within the meaning of §§ 61 and 1001 of the Internal Revenue Code, and if that question be answered as the court below answered it, whether the statutes are valid under Article I, § 2, cl. 3, and Article 1, § 9, cl. 4, of the Constitution and the Sixteenth Amendment. Furthermore the decision takes on added importance as an *ad hoc* curtailment of the scheme of tax incentives long ago placed on the statute books by Congress to encourage the creation and current funding of private pension systems. Today these plans with assets of over $66 billion (R. 206) constitute a vital adjunct to Social Security. In view of the general importance of these questions, and because the judgment below departs

from settled law and fails to take into consideration the intent of Congress as clearly revealed in the legislative history of the statute which the decision below purports to construe but in substance negates, the case should be reviewed by this Court.

FIRST. On the precise question presented there appears to be no decision of any court other than the judgment below and *United States* v. *General Shoe Corp.*, 282 F. 2d 9, cert. den. 365 U. S. 843,[7] decided in the Sixth Circuit in 1960 and heavily relied on by the Court of Claims here. Prior to these two decisions it had been the recognized rule that in the case of an annuity venture by a non-insurance company annuity writer, where the annuitants were identified and the annuity payments had commenced, gain or loss is not determined and so cannot be taken into account by the annuity

[7] As counsel understands the petition for certiorari in *General Shoe*, it was based on a ground wholly different from the reasons here relied on. In substance *General Shoe* argued that it realized no gain because the employer advantage of the plan received by it in exchange for its contribution had no independent market value which could be compared with the cost of the contributed property. Unlike the case at bar, there was no argument in *General Shoe* that the employer advantage of the plan was in fact not received in exchange for the contributions; and that in fact the contribution was not part of a transaction closed in the taxable year of contribution. After denying certiorari in *General Shoe*, this Court held at the next term that on an exchange the property received by the taxpayer need not have an independent value; and that if it has none, the value of the property transferred by the taxpayer may be attributed to the property received, with resultant realization of gain or loss. *United States* v. *Davis*, 370 U. S. 65. In *Davis*, there was no question that the transaction was closed. It was regarded by the taxpayer as a "division of property between two co-owners" and by the government as a "transfer of property in exchange for the release of an independeent legal obligation" (370 U. S. p. 69).

writer until all the annuitants are dead. Rev. Rul. 55-119, citing *Mastin* v. *Commissioner,* 28 F. 2d 748; *Citizens National Bank* v. *Commissioner,* 122 F. 2d 1011, cert. den. 315 U. S. 822; and *D. Bruce Forrester,* 4 T. C. 907. To the same effect see also *Kaufman's, Inc.,* 28 T. C. 1179, 1183-6, acq. 1958-2 C. B. 6; *Rhinehart Farms, Inc.* v. *United States,* 3 A. F. T. R. 2d 483. *A fortiori* this was true in the case at bar where petitioner's contributions were made to fund a plan, the major portion of the actuarial liabilities of which were for future pensions to annuitants who might lose their rights through severance or pre-retirement mortality. Furthermore prior to the decisions below and in *General Shoe* it appeared to be settled that where, as here, appreciated securities are transferred to a fund to be held on account of a continuing liability and the securities remain unsold, the transfer does not realize the appreciation. Rev. Rul. 59-47, 1959-1 C. B. 198. Also, it was deemed horn book learning that where, as here, capital assets are exchanged, gain does not accrue until the taxable year in which the transaction is completed and closed. *Burnet* v. *Logan,* 283 U. S. 404, 413; *Lucas* v. *North Texas Co.,* 281 U. S. 11, 13. Neither in the decision below nor in *General Shoe* did the court mention any of these principles or authorities. In deciding that income in the form of gain from the exchange of capital assets accrued to petitioner from its pension plan contributions in 1954 and 1955, the court below gave a novel and importantly changed meaning to two of the basic provisions of the Internal Revenue Code, §§ 61 and 1001.

SECOND. If the court below was right that §§ 61 and 1001 place within the ambit of the federal income tax the appreciation in securities contributed to a pension

plan under the state of facts herein obtaining, then a constitutional question is raised as to the validity of the statutes. As this Court has pointed out, "it is not necessarily true that income means the same thing in the Constitution and the act." *Towne* v. *Eisner*, 245 U. S. 418, 425. As used in the Constitution, "enrichment through increase in value of capital investment is not income in any proper meaning of the term." *Eisner* v. *Macumber*, 252 U. S. 189, 214-15. If §§ 61 and 1001 subject unrealized appreciation to the federal income tax then to that extent the tax is an unapportioned levy on capital, forbidden by Article I, § 2, cl. 3, and Article I, § 9, cl. 4, of the Constitution, notwithstanding the Sixteenth Amendment. *Eisner* v. *Macumber*, *supra*.

THIRD. The decision below constitutes an *ad hoc* interference with the comprehensive scheme of Congressional policy long in effect with respect to private pension systems.[8] While this program of tax incentives to

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[8] See the following provisions of the Internal Revenue Code: § 404(a)(1), making employer contributions to fund a qualified plan income tax deductible; § 501(a), making the pension fund under a qualified plan income tax exempt; § 402(a)(1), exempting the participants in a qualified plan from income tax on undistributed vested benefits; § 402(a)(2), according capital gains treatment to certain amounts distributed under a qualified plan; § 2039(c), exempting from estate tax the value of an annuity receivable by the beneficiary of a deceased participant in a qualified plan; § 2517, exempting from gift tax the exercise of an election whereby an annuity will become payable to the beneficiary of a participant in a qualified plan.

For a statement of the policy of Congress, see, *e.g.* the following remarks made by Mr. Disney of the Ways and Means Committee to the House regarding § 144 of the Revenue Bill of 1942, H. R. 7378, 77th Cong., as reported by the Ways and Means Committee:

> "Through favorable tax treatment with respect to pension trusts and other retirement plans we have endeavored to encourage employers to provide for their superannuated

encourage the creation and current funding of pension plans dates back to the Revenue Act of 1921,[9] the law attained substantially its present form by the overall revision of §§ 23(p) and 165 of the 1939 Code effected by the Revenue Act of 1942. By the amendment to § 165, tax benefits were limited to plans under which 70 percent of the employees were eligible to participate and which benefited at least 80 percent of those eligible, under which employer contributions were irrevocable, and under which the scheme of benefits did not discriminate in favor of management employees.[10] A question then arose as to the scope of the tax deduction to be afforded to employers in respect of their contributions toward the funding of plans which met these requirements. In the bill as reported by the Ways and Means Committee with Treasury support, the deduction would have been limited to contributions constituting compen-

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employees. There are three aspects to this problem: First, whether the employer is entitled to a deduction for the amount set aside to provide the pension payments; second, as to whether the trust is taxable upon the income accruing to it; and, third, as to the treatment to be accorded the employee, both in the year in which the employer pays in the trust on his account and in the later year in which he receives the pension benefits. The present law is very liberal in this respect. Employers may deduct all amounts irrevocably set aside in a pension trust. Such trusts are not taxable upon income accruing to them and the employee is not taxed in the year in which the employer pays the amount into the trust." (88 Cong. Rec. 6378)

[9] See § 219(f) of the Revenue Act of 1921; § 219(f) of the Revenue Act of 1926; §§ 23(a), 23(q) and 165 of the Revenue Act of 1928; §§ 23(p) and 165 of the Revenue Act of 1938.

[10] Revenue Act of 1942, § 162(a), Public Law No. 753, § 162(a), 77th Cong., 56 Stats. 798, 862. This provision was § 165(a) of the 1939 Code and is now § 401(a) of the 1954 Code.

sation.[11] In the hearings on the bill, this attempted change in existing law was opposed by representatives of employers having pension plans, who argued that it would in effect convert all pension plans into deferred compensation plans, an undesirable development.[12] The Senate Finance Committee reported a revised provision eliminating the change by permitting a deduction *either* for a contribution which constituted deferred compensation *or* for a contribution to a pension or profit shar-

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[11] H. R. 7378, § 144(b), 77th Cong., as reported by the House Ways and Means Committee (see H. Rep. 2333):

> "DEDUCTION ALLOWED EMPLOYER.—Section 23(p) (relating to deduction for amounts paid to pension trusts) is amended to read as follows:
>
> (p) COMPENSATION PAID FOR PERSONAL SERVICES UNDER A TRUST, ANNUITY, OR DEFERRED-PAYMENT PLAN.—
>
> (1) *General Rule.*—If compensation for personal services rendered is paid or accrued on account of any employee under a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of such compensation, then such compensation shall not be deductible under subsection (a) but shall be deductible, if deductible under subsection (a) without regard to this subsection, under this subsection but only to the following extent: . . . ."

Mr. Randolph Paul, then Tax Advisor to the Secretary of the Treasury, testified in support of § 144(b). Hearings on H. R. 7378, Ways and Means Committee, 77th Cong. 2nd Sess., pp. 87, 1004-5, 2406-7.

[12] Hearings on H. R. 7378, Ways and Means Committee, 77th Cong. 2d Sess., pp. 879-80, 2412, 2438-40, 2446, 2465-6.

ing plan.[13] Congress enacted the Senate measure,[14] which has ever since remained on the statute books.[15] For these reasons, urged by petitioner in the court below, a determination that under § 404(a) the contribution is deductible as gain-realizing compensation or not at all, deprives petitioner of what Congress determined that it should have, namely a deduction for a contribution which does not constitute compensation.

If the legislative policy as to pension plans is to be changed, this can be accomplished constitutionally and effectively only by Congress, acting after hearings and deliberation on the broad lines of the complex subject matter involved. Meanwhile the existing structure should be protected from piecemeal encroachment of the Internal Revenue Service and the lower federal courts.

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[13] H. R. 7378, § 164(b), 77th Cong., as reported by Senate Finance Committee:

> "DEDUCTION ALLOWED EMPLOYER.—Section 23(p) (relating to deduction for amounts paid to pension trusts) is amended to read as follows:
>
> (p) CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN.—
>
> (1) *General Rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under subsection (a) but shall be deductible, if deductible under subsection (a) without regard to this subsection, under this subsection but only to the following extent: . . . ."

[14] Revenue Act of 1942, 77th Cong. Public Law No. 753, § 162(b), 56 Stats. 798, 863.

[15] § 23(p), I. R. C. (1939); § 404(a), I. R. C. (1954).

FOURTH

~~THIRD~~. The judgment below departs from settled law in respects other than those mentioned above with respect to the construction of §§ 61 and 1001.

(a) The theory relied on by the court below and by the Sixth Circuit Court of Appeals in *General Shoe, supra,* that when a taxpayer parts with appreciated property in making a tax deductible transfer and uses the appreciated value as the measure of his deduction he somehow realizes the appreciation, is neither valid or new. Seeking to extend the doctrine of *Helvering* v. *Horst,* 311 U. S. 112, from a case where the assignor was taxed on bond income which he gave away in the taxable year in which it became payable to a case where the assignor would be taxed on the appreciation on a capital asset which he gives away, the Internal Revenue Service promulgated I. T. 3910, 1948-1 C. B. 15 and I. T. 3932, 1948-2 C. B. 7. The first ruled that where the taxpayer made a charitable donation in property and deducted the market value, he thereby realized gain measured by that market value. The second was a similar ruling with respect to a gift to an individual. In *Campbell* v. *Prothro,* 209 F. 2d 331, *Winton* v. *Kelm,* 122 F. Supp. 649, and *White* v. *Broderick,* 104 F. Supp. 213, the courts rejected the contention of the Internal Revenue Service that the taxpayer realized income by a charitable contribution; and in *Estate of W. G. Farrier,* 15 T. C. 277, 283-4, *Elsie SoRelle,* 22 T. C. 459, 477, acq. 1955-1 C. B. 6, and *Apt* v. *Birmingham,* 89 F. Supp. 361, the courts reached the same result where the gifts were to individuals. Thereupon the Internal Revenue Service revoked I. T. 3910 by Rev. Rul. 55-138, 1955-1 C. B., 223;[16] and it revoked I. T. 3932 by Rev. Rul. 55-

[16] To the same effect, see also Rev. Rul. 55-275, 1955-1 C.B. 295, 297; Rev. Rul. 55-410, 1955-1 C.B. 297; Rev. Rul. 57-328, 1957-2 C.B. 229.

531, 1955-2 C. B. 520. To be sure in the case at bar the contributions were not donated; they were business transactions made for business reasons. But the Court of Claims failed to apply the test by which it is determined whether a business transaction results in gain. It ignored the test stated by this Court in *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179,[17] now codified in § 1001 of the 1954 Code, and the test of *Burnet* v. *Logan, supra,* and *Lucas* v. *North Texas Co., supra.* It ignored these tests by refusing to make findings on undisputed facts which showed that petitioner received nothing in exchange for the contributions and that they were not part of transactions closed and completed in the taxable year of contribution. By those omissions the court left this case with the same lack of evidence of realized gain as that which obtained in the donation cases cited above.

(b) Concededly under § 404(a), I. R. C., a pension plan contribution to be deductible must not only fall within one of the limiting formulas of § 404(a)(1); it must also constitute ordinary and necessary expense under § 162 or § 212. But to be deductible as ordinary and necessary expense, an amount need not be part of a closed transaction. The two concepts exist in different planes of reference. A closed and completed transaction is what must exist in order that the sale, exchange or conversion of a capital asset can result in

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[17] In determining how gain or loss from the sale, exchange or conversion of capital assets should be determined under the Corporation Excise Tax Act of 1909, this Court said:

> "In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value as it existed at the commencement of the period under consideration." (247 U. S. p. 185)

gain (*Burnet* v. *Logan, supra; Lucas* v. *North Texas Co., supra*) or loss (*United States* v. *White Dental Co.*, 274 U. S. 398, 400-1; *Weiss* v. *Wiener*, 279 U. S. 333, 355-6). The cost of a capital asset is never ordinary and necessary expense or deductible per se. Instead it is stored in the taxpayer's basis and carried forward until the asset is realized on in a closed transaction, on which taxable year gain or loss is determined by matching that basis against the money or property received by the taxpayer. § 1001, I. R. C. On the other hand certain amounts paid or incurred for consideration other than the purchase of a capital asset, namely as ordinary and necessary expenses of the continuing activity of carrying on a trade or business (§ 162), or of collecting income or conserving income producing property (§ 212), are deductible in the year paid or incurred and only in that year. This dichotomy was pointed out by this Court in *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359. There, in the period 1913-1916 a cash basis taxpayer paid out in respect of a dredging contract ordinary and necessary business expenses which exceeded its receipts by $176,271.88, for which excess it received reimbursement in 1920 through satisfaction of a final judgment in a suit on the contract. In its return for 1920 the taxpayer offset the excess disbursements against the receipt. The Commissioner of Internal Revenue disallowed the deduction and assessed a tax on the receipt. In sustaining the Commissioner, this Court held that unlike the cost of a capital asset, these ordinary and necessary business expenses were deductible only in the years paid or incurred, despite the circumstance that the contract was not discharged until a later year. 282 U. S. pp. 363-4.

II

IN THE CASE AT BAR THE COURT OF CLAIMS HAS RENDERED A DECISION IN CONFLICT WITH THE DECISION OF THE SIXTH CIRCUIT COURT OF APPEALS ON THE SAME MATTER.

The decision of the Court of Claims, as above noted, is based largely on the sweeping proposition that in the context of a pension plan contribution "ordinary and necessary expense" as used in §§ 162 and 212, I. R. C., is limited to compensation paid for services actually rendered; and so the Tax Court held in *Lincoln Electric Co.*, 6 T. C. 37. Having determined that premiums paid in 1940 by an employer to an insurance company under a group annuity plan for retirement pensions to its employees did not constitute compensation within the meaning of § 23(a) of the 1939 Code because there were too many uncertainties between the contributions and the benefit payments, the court held:

> "We have already decided that these payments were not 'compensation [paid].' Section 23(a) deals specifically with 'compensation [paid].' It describes particularly the payments of compensation for services which are allowable as deductions. Such payments are not allowable unless they fall within those specifications. Under the doctrine of *'inclusio unius est exclusio alterius'* we think the section denies the deduction of such payments for services, regardless of their designation, since they fall outside the field of allowable compensation deductions" (6 T. C., p. 55).

On appeal, the Sixth Circuit Court of Appeals reversed the judgment on the ground that, as a matter of law, the

statute means that reasonable and necessary expense *may* include a pension plan contribution which *does not* constitute compensation. *Lincoln Electric Co.* v. *Commissioner*, 162 F. 2d 379, 382-5.[18] As the court observed at the last cited page:

> "We think the Tax Court was in error in its interpretation of the law and its decision should be set aside."

CONCLUSION

The decision below, too broad in that it finds gains realized as a matter of legal presumption, contrary to the facts, and too narrow in that it would limit pension plan contribution deductions to compensation for services actually rendered, contrary to the law, raises important questions of statutory construction, of constitutionality, and of the effect to be accorded to Congressional policy having wide economic and social influence.

A writ should be granted as prayed.

Respectfully submitted,

ROBERT P. WEIL
Attorney for petitioner

Dated, New York, N. Y.
October 12, 1966

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[18] *Lincoln Electric Co.* v. *Commissioner*, 162 F. 2d 379, was cited with approval by the Sixth Circuit Court of Appeals in *General Shoe*. See 282 F. 2d p. 11.

APPENDIX

United States Constitution

ARTICLE I, § 2, cl. 3:

"Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers. . . ."

ARTICLE I, § 9, cl. 4:

"No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration hereinbefore directed to be taken."

SIXTEENTH AMENDMENT:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several State, and without regard to any census or enumeration."

Internal Revenue Code of 1954

§ 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * *

(3) Gains derived from dealings in property. . . ."

* * *

§ 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * *

§ 404. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN.

(a) *General Rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under § 162 (relating to trade or business expenses) or § 212

(relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

(1) PENSION TRUSTS.—In the taxable year when paid, if the contributions are paid into a pension trust, and if such taxable year ends within or with a taxable year of the trust for which the trust is exempt under § 501(a), in an amount determined as follows:

(A) an amount not in excess of 5 percent of the compensation otherwise paid or accrued during the taxable year to all the employees under the trust, but such amount may be reduced for future years if found by the Secretary or his delegate upon periodical examinations at not less than 5-year intervals to be more than the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan, plus

(B) any excess over the amount allowable under subparagraph (A) necessary to provide with respect to all of the employees under the trust the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee, as determined under regulations prescribed by the Secretary or his delegate, but if such remaining unfunded cost with respect to

any 3 individuals is more than 50 percent of such remaining unfunded cost, the amount of such unfunded cost attributable to such individuals shall be distributed over a period of at least 5 taxable years, or

(C) in lieu of the amounts allowable under subparagraphs (A) and (B) above, an amount equal to the normal cost of the plan, as determined under regulations prescribed by the Secretary or his delegate, plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount not in excess of 10 percent of the cost which would be required to completely fund or purchase such pension or annuity credits as of the date when they are included in the plan, as determined under regulations prescribed by the Secretary or his delegate, except that in no case shall a deduction be allowed for any amount (other than the normal cost) paid in after such pension or annuity credits are completely funded or purchased.

* * *

§ 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) COMPUTATION OF GAIN OR LOSS.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * *

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 677

THE A. P. SMITH MANUFACTURING COMPANY,
PETITIONER

v.

THE UNITED STATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

In 1954 and 1955, petitioner, a manufacturing corporation, made voluntary contributions of stock (shares of other corporations) to a pension trust created for the benefit of its employees. It treated the contributions as payments of business expenses on its 1954 and 1955 income tax returns, deducting from its gross income the fair market value of the stock as of the date of each transfer to the trust.[1]

[1] Section 404(a) of the Internal Revenue Code of 1954 permits an employer to deduct contributions to certain employees'

The Commissioner allowed the deductions, but determined that petitioner realized gain to the extent that the fair market value of the stock transferred exceeded its adjusted basis. The gain thus calculated, amounted to approximately $53,000 for 1954 and $34,000 for 1955.[2] Petitioner paid the deficiencies and brought this suit after rejection of its refund claims. The Court of Claims upheld the Commissioner's determination. (R. 333, 340, 342, 343-344, 346-347.)

The decision of the Court of Claims is correct. There is no conflict of decisions or other circumstance warranting further review.

1. The stock transfers were taxable "disposition[s] of property," within the purview of 1954 Code § 1001(a), because the stock was transferred in payment of an ordinary and necessary business expense. See *United States* v. *General Shoe Corp.*, 282 F. 2d 9 (C.A. 6), certiorari denied, 365 U.S. 843; *International Freighting Corp.* v. *Commissioner*, 135 F. 2d 310 (C.A. 2); *Montana Power Co.* v. *United States*, 171 F. Supp. 943 (Ct. Cl.). Petitioner, although under no legal obligation, transferred the stock to the employee pension trust in response to conditions in the labor market. These expenditures were intended

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pension plans (and other similar plans) if the contributions qualify as ordinary and necessary trade or business expenses under Code § 162 (Pet. 24-25).

[2] The Commissioner originally asserted that the gain constituted ordinary income, but later conceded in court that the gain was taxable as capital gain (R. 333).

to have an effect similar to the payment of salaries, bonuses, and other more direct forms of compensation. (See R. 342-343, Findings 4(i), 5.) Like the payment of bonuses and salaries, the stock transfers reduced the risk of losing employees to higher paying competitors and were a means of preventing labor disputes. Since petitioner's dispositions of the securities resulted in an economic benefit to it, they were taxable events.

In *United States* v. *Davis*, 370 U.S. 65, the taxpayer had transferred appreciated property to his former wife incident to a divorce. The Court held that this "transaction was * * * a taxable event" (370 U.S. at 71) and that, in the absence of contrary evidence, it must be assumed that the economic benefit to the taxpayer (from his ex-wife's release of her marital rights) was equal to the value of the property which he transferred. In this regard the Court said (pp. 72-73):

> once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences. * * *

It is especially appropriate to assume that a taxpayer received full value for his expenditures in a case, like the instant one, which involves carefully considered business arrangements. It is clear that petitioner would have been liable for the capital gain tax here in controversy, if, instead of transferring

the stock to the pension trust in kind, it had sold the stock and transferred the proceeds to the trustee.

2. There is no conflict of decisions. The Sixth and Second Circuits have also held that a taxpayer realizes gain when it transfers appreciated property to a pension trust or uses it to pay employee bonuses. *United States* v. *General Shoe Corporation*, 282 F. 2d 9 (C.A. 6), certiorari denied, 365 U.S. 843 (pension trust); *International Freighting Corp.* v. *Commissioner*, 135 F. 2d 310 (C.A. 2) (employee bonus awards). This Court cited both of those decisions with approval in *United States* v. *Davis*, *supra*, 370 U.S. at 72.

Petitioner argues that the instant decision conflicts with *Lincoln Electric Company* v. *Commissioner*, 162 F. 2d 379 (C.A. 6). In that case the Sixth Circuit held that the taxpayer's contributions to an employee pension plan qualified for a tax deduction as ordinary and necessary business expenses whether or not they could be labelled compensation for services rendered. The instant Court of Claims decision is not in conflict with *Lincoln Electric*, since here the Commissioner permitted the deductions and the only question is whether the petitioner realized gain to the extent of the appreciation in the value of the contributed property.[3]

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[3] Petitioner also cites cases holding that a transfer of appreciated property by gift does not constitute a taxable event (Pet. 17-18). These cases are not relevant here where petitioner did not give the appreciated securities away, but obtained an economic benefit by transferring them "for business reasons" in payment of ordinary and necessary business expenses (Pet. 18).

3. Nor is there merit in petitioner's argument, in reliance upon *Burnet* v. *Logan*, 283 U.S. 404, that the transfers to the pension trust were not "closed" transactions. In *Burnet* v. *Logan* this Court held that the recognition of gain should be postponed where a taxpayer transferred stock in exchange for the right to receive "future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty" (p. 413). Therefore, the Court held that the "transaction was not a closed one" (*ibid.*) and that the taxpayer should wait until the payments were received, and then, after recovering her capital investment, report the additional payments as gain. In this case, however, as in *United States* v. *Davis*, *supra*, the taxpayer was not entitled to receive any later payments in consideration for the transfer of the appreciated property. Just as the taxpayer in *Davis* realized gain when he satisfied his marital obligations with appreciated property, petitioner realized gain when it paid business expenses with appreciated property. Nothing more was needed to make the transactions more certain or final.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

None of the arguments presented in the Government's brief in opposition is relevant to the question presented.

The question presented is whether, as held below, there should exist a rule of law that an employer's annual contribution to its self-administered fixed benefit pension plan constitutes a final purchase by the employer of the plan advantages thought to accrue to the employer in the year of contribution, so that where, as here, the contribution is made in appreciated property, the appreciation is thereby realized as taxable gain of the year of contribution. Ought there to be a rule of law so strong that the courts must brush aside an undisputed record of fact* showing that the ad-

*In the case at bar the Commissioner admitted petitioner's evidence (R. 337, R. 137-232) but refused (R. 338) to make findings (R. 73-127) thereon.

vantages of such a plan flow toward the employer not in consideration of its annual contributions or the lack of them, but because of the employees' continuing expectation that on retirement they will be paid life annuities in accordance with the plan formula, the cost of which cannot be known or accurately estimated in the year of contribution? Ought there to be a rule so strong that courts must hold that where, as here, the contributed property remains unsold or partly unsold at the close of the taxable year, gain is to be deemed realized although a further unknown obtains as to the extent to which the contributed property will, when sold, provide dollars toward meeting future pension costs? Can this so strong position be maintained without the prop of a statute limiting employer deductions for pension plan contributions to deferred compensation for services actually rendered, a limitation which Congress has expressly refused to impose (pet. 14-16)?

1. The Government argues (br. 2) that "the stock was transferred in payment of an ordinary and necessary business expense." Of course if the stock had been transferred in full satisfaction of the cost of a desired business advantage, the appreciation would have been realized thereby. *International Freighting Corp.* v. *Commissioner,* 135 F. 2d 310, 313 (C. A. 2); *Philadelphia Park Amusement Co.* v. *United States,* 130 Ct. Cl. 166. But a payment on account of an item of expense, which item is indeterminate in amount at the close of the taxable year, is incapable of such realization even though it constitutes ordinary and necessary business expense. *Burnet* v. *Logan,* 283 U. S. 404, 413. Here the court, at the Government's urging, refused to consider evidence which showed that the contributions were in fact payments on account (pet. 5-9).

In the same vein, the Government argues (br. 3):

> "Like the payment of bonuses and salaries, the stock transfers reduced the risk of losing employees to higher paying competitors and were a means of preventing labor disputes. Since petitioner's disposition of the securities resulted in an economic benefit to it, they were taxable events."

Thus the Government would gloss over the distinction between contributions to a fixed benefit self-administered plan and the plan itself. Accepting the Government's position, the court, as shown above, held irrelevant the record facts which showed that the employer advantages deriving from the plan in a given year are in no way related to the employer's contribution or failure to contribute in that year, but were received by the employer in consideration of the employees' expectation that retirement pensions would be paid in full (pet. 5-9). Thus again, in opposition to this application the Government is stating as an unsupported conclusion the reverse of what is shown by undisputed evidence which the Government persuaded the court below to refuse to consider.

2. *United States* v. *Davis*, 370 U. S. 65, relied on by the Government, is clearly distinguishable from the case at bar. In *Davis* in exchange for appreciated securities a husband received consideration in a closed transaction, i.e., "his ex-wife's release of her marital rights . . ." (br. 3). Petitioner concedes that where, as there, appreciated property with a market value is transferred by the taxpayer in a closed transaction in exchange for property without market value, the

value of the first mentioned property may be attributed to the second mentioned property, and the appreciation in the first mentioned property thereby realized. In the case at bar, on the contrary, there was no closed transaction in either taxable year.

3. As a prop for the decision below, the Government urges further (br. 3-4) "that petitioner would have been liable for the capital gain tax here in controversy, if, instead of transferring the stock to the pension trust in kind, it had sold the stock and transferred the proceeds to the trustee." Both the facts and the law show the fallacy of this claim. If petitioner had sold the securities, its venture in them would have been ended and they would have been converted into $125,000 toward pension payments (R. 344). Under the transaction which in fact occurred, the end of the taxable year of each contribution found it undetermined how much the contributed securities would, when sold, produce toward pension costs over and above the $36,000 which the securities had cost (R. 344). To be sure, petitioner was not legally bound to see pensions paid (R. 345), but could fail to do so only at the risk of losing its labor force and being put out of business (R. 343, 211, 217). Even if this were not so—even if, on the contrary, the economic effect on petitioner of contributing in kind had been identical with the effect of sale and contribution of the proceeds, it is well settled that a taxpayer may not be taxed on the transaction which it chose not to make, and in fact did not make, whether or not the choice was made with an eye to minimizing its taxes. *Bullen* v. *Wisconsin*, 240 U. S. 625, 630; *Lewyt Corp.* v. *Commissioner*, 349 U. S. 237, 240; *United States* v. *Cumberland Public Service Co.*,

338 U. S. 451, 455-6; *Hanover Bank* v. *Commissioner*, 369 U. S. 672, 687-8.

4. The Government's attempt (br. 4) to show that no conflict obtains between the decision below and *Lincoln Electric Co.* v. *Commissioner*, 162 F. 2d 379 (C. C. A. 6), is clearly unavailing. *Lincoln Electric* stands for the proposition that a pension plan contribution need not constitute compensation to be deductible (162 F. 2d pp. 380, 382, 385), while the court below held the other way in the case at bar (R. 339-40).

5. Likewise unavailing is the Government's attempt (br. 5) to explain away the error below in failing to give effect to the rule that neither gain nor loss may be taken into account for tax purposes until the sale, exchange or conversion on which it is alleged to have been realized is completed and closed. Although in *Burnet* v. *Logan, supra*, it was expected that the taxpayer would receive, in the transaction in question, further payments in later years, the rule is not limited to such a state of facts. It applies equally where, as here, the taxpayer remains under continuing liability. Rev. Rul. 59-47, 1959-1 C. B. 198. Furthermore the facts deemed irrelevant by the court below show that a self-administered fixed benefit pension plan is in fact a continuing flow from the institution of the plan until its termination, not a series of annual segments; and this is so from the standpoint of employee benefits, employer advantage, cost, and cost deduction. The correlation between this long-range effort at social engineering and the income tax system based on annual rests and accountability for annual periods is based on a program of tax incentives offered by Congress as a matter of long standing policy to bring about the estab-

lishment and current funding of "qualified" private retirement systems (pet. 13-16). Among those incentives are the right to deduct contributions annually, estimated as a level premium from entry into the plan to retirement, *e.g.* § 404(a)(1)(B), I. R. C.; and another is the right to deduct a contribution in property at market value. *Colorado National Bank of Denver*, 30 T. C. 933, acq. 1959-1 C. B. 3.

The petition should be granted as prayed.

Respectfully submitted,

ROBERT P. WEIL
Counsel for petitioner

December, 1966